

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 00-0442
Adjusted Gross Income Tax
For Tax Years 1996 through 1998**

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ISSUE

I. Adjusted Gross Income Tax— Method of Calculation

Authority: 45 IAC 3.1-1-153

Taxpayer protests the auditor's decision that the partnership distribution should be treated as allocated income for Indiana adjusted gross income tax purposes.

**II. Adjusted Gross Income Tax— Allocation of Corporate Partnership Distributive Share:
Sale of Contracts**

Authority: *Hunt Corporation v. Indiana Dept. of State Revenue*, 709 N.E.2d 766 (Ind. Tax Ct. 1999); IC 6-3-2-2; 45 IAC 3.1-1-153

Taxpayer protests the auditor's determination that income from the sale of contracts, received as a part of taxpayer's distributive share of partnership income, was allocable to Indiana for adjusted gross income tax purposes.

**III. Adjusted Gross Income Tax— Allocation of Corporate Partnership Distributive Share:
Interest Income**

Authority: 45 IAC 3.1-1-153

Taxpayer protests the auditor's determination that interest income, received from taxpayer's distributive share of partnership income earned from the long-term investment of the partnership's excess cash, was allocable to Indiana for adjusted gross income tax purposes.

STATEMENT OF FACTS

Taxpayer is a partner in an out-of-state partnership that is in the business of providing consumer information (hereinafter, "Partnership"). The Partnership was formed to operate debt collection and credit verification functions. The Partnership is affiliated with a large corporation headquartered in California. Taxpayer was involved in the business of debt collection prior to becoming a partner in the Partnership. Taxpayer asserts that it holds its interest in the Partnership as an investment. All of taxpayer's income is from the Partnership through a distributive share.

The Department of Revenue conducted an audit for the years in question and issued various tax assessments against taxpayer. Additional facts will be supplied as necessary for discussion.

I. Adjusted Gross Income Tax— Method of Calculation

DISCUSSION

In its income tax return, Taxpayer apportioned its partnership income based upon its percentage of ownership of the Partnership as related to the net income. However, citing 45 IAC 3.1-1-153, the auditor determined that partnership distributions should be treated as allocated income for Indiana adjusted gross income tax purposes. As such, all of the net income that taxpayer apportioned was removed from the audit report; and, only the allocated distributive share of the partnership income attributable to Indiana was included as being subject to tax. Taxpayer disagrees with the auditor's method.

Upon completion of its audit of taxpayer, the auditor determined that taxpayer and the Partnership were non-unitary. Taxpayer offered no evidence to refute the auditor's determination. 45 IAC 3.1-1-153 dictates that when a corporate partner and its corporate partnership are non-unitary, the corporate partner's share of the partnership's business income attributable to Indiana is determined by applying a three-factor formula consisting of the property, payroll, and sales of the Partnership. The apportioned amount is then allocated to Indiana for adjusted gross income tax purposes. The auditor followed the mandates of the regulation in determining the amount of tax taxpayer owed on its distributive share of the Partnership income. No error occurred here.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax— Allocation of Corporate Partnership Distributive Share: Sale of Contracts

DISCUSSION

Taxpayer, a corporate partner of a corporate partnership, has characterized the income from the sale of consumer contracts, received as part of taxpayer's distributive share of partnership income, as non-business income. According to taxpayer, the contracts sold were located throughout the East, the South, and the Middle-West regions of the United States. There were no

contracts located, or any services performed in Indiana. Taxpayer is adamant that the activities of the sale of the contracts did not occur in Indiana, and did not occur in the regular course of taxpayer's business, *i.e.*, a shareholder of the Partnership. According to taxpayer, the sale of the contracts was for investment purposes only, and not an integral part of taxpayer's regular business. Therefore, taxpayer requests that the proceeds from the sale of the contracts be classified as non-business income allocable to California, the state in which taxpayer is domiciled.

Corporate partners are taxed on their distributive share of the partnership's Indiana source income. The determination of the source of a partnership's income differs based upon whether or not the partnership maintains a unitary relationship with the corporate partner. The relevant regulation for determining the source of a partnership's income is 45 IAC 3.1-1-153.

45 IAC 3.1-1-153(b) states in relevant part that:

[i]f the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors. . .

45 IAC 3.1-1-153(c) provides in relevant part that:

[i]f the corporate partner's activities and the partnership's activities *do not* constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows:

(1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the *partnership*. (*Emphasis Added*).

The effect of the regulation is that partnership income is apportioned only once; and, that apportionment may take place at either the corporate partner or the corporate partnership level depending on whether or not a unitary relationship exists between the corporate partner and the partnership.

On its face, regulation 45 IAC 3.1-1-153 does not appear to address whether or not a partnership may have non-business income at either the corporate partner or corporate partnership level. However, regardless of the relationship between the corporate partner and the corporate partnership, it is clear that the regulation refers to the apportionment of "business income." Nevertheless, to clarify the regulation and how it deals with non-business income it is necessary to examine the reasoning found in the Tax Court case *The Hunt Corp. v. Department of State Revenue*, 709 N.E.2d 766 (Ind. Tax 1999).

In *Hunt*, the Court determined that a corporate partner's income from a corporate partnership should be determined by apportionment of that income at the corporate partner level when the corporate partner and the corporate partnership enjoy a unitary relationship. *Id.* At 778. The Court made its determination based on the application of IC 6-3-2-2, the general provision that deals with how all of a corporate taxpayer's adjusted gross income is attributed by way of allocation and apportionment rules. Although the Court found that 45 IAC 3.1-1-153 was not applicable to the years at issue, the Court discussed the regulation at length and appeared to endorse it as a reasonable interpretation of the applicability of IC 6-3-2-2 to corporate partnerships. *Hunt*, 709 N.E.2d at 777. After determining that IC 6-3-2-2 applied to corporate partnerships, the Court in *Hunt* stated:

If the income from the partnerships constitutes business income (i.e., if the affiliated group and the partnerships are engaged in a unitary business), under section 6-3-2-2, all of that income would be subject to apportionment based on an application of the affiliated group's property, payroll, and sales factors. If the income from the partnerships constitutes non-business income for the affiliated group (i.e., if the affiliated group and the partnerships are not engaged in a unitary business), that income would be allocated to a particular jurisdiction. (Emphasis Added).

Id. at 776.

The Court's reasoning in *Hunt* is clear: all of a corporate partner's income from a corporate partnership that enjoys a unitary relationship with that partner is business income; all of a corporate partner's income from a partnership with a non-unitary relationship is non-business income. Therefore, applying the reasoning in *Hunt*, there is no "business versus non-business" determination at the partnership level regardless of the relationship between the partner and the partnership.

In the instant case, it was determined that taxpayer and the Partnership did not enjoy a unitary relationship. However, while the income from a non-unitary partnership will be classified as non-business income, it is important to note that said income will not necessarily be allocated to a single state. When the non-business income is derived from sources within and without Indiana, the allocation is based on an apportionment of all partnership income at the partnership level. Although 45 IAC 3.1-1-153(c)(1) uses the term "business income" to describe the partnership income to be allocated through a factor apportionment, this description does not result in a characterization of that income as "business income" that flows through to the corporate partner. Such an interpretation would contradict the Court's findings in *Hunt*. See *Hunt*, 709 N.E.2d at 776. Further, the Court in *Hunt* comments in footnote number twenty-eight, that allocation of the income through a factor apportionment is necessary because it ensures that Indiana will be able to receive its fair share of income from a partnership doing business in Indiana. *Id.* at 777.

FINDING

Taxpayer's protest is denied. The Department did not err in calculating the apportionment percentage of the Partnership income earned in Indiana, and allocating said amount to Indiana for adjusted gross income tax purposes.

III. Adjusted Gross Income Tax— Allocation of Corporate Partnership Distributive Share: Interest Income

DISCUSSION

Taxpayer contends that its distributive share of the interest income derived from the Partnership's long-term investment of excess cash is non-business income for the purpose of computing Indiana Adjusted Gross Income Tax. Taxpayer argues that the interest income arises from passive investments unrelated to the taxpayer's primary business. The auditor found that in 1996 and 1997, taxpayer treated its distributive share of interest income from the Partnership as business income. In 1998, however, taxpayer treated the interest income as non-business income and allocated said income to California. The auditor determined that taxpayer was clearly not unitary with the partnership, therefore pursuant to 45 IAC 3.1-1-153(c)(1) the auditor allocated the Indiana share of the income to the taxpayer.

Pursuant to 45 IAC 3.1-1-153(c) all of the partnership's income is required to be allocated based on the three-factor formula therein. As the partnership is not the taxpayer, the business non-business analysis takes place at the partnership's distribution to the taxpayer level.

FINDING

Taxpayer's protest is denied.